



Global Economy Report

May 2014



Global Economy Report

The Global Economy Report is prepared in cooperation by the Macroeconomic Research Division of Banca Aletti and the Global Governance Programme of the Robert Schuman Centre for Advanced Studies of the European University Institute.

The objective of the Report is to provide an analysis of the current and expected macroeconomic and financial conditions at the global level, with also a focus on key economic areas such as Europe, the USA and ASIA.

This report has been prepared by:

- Daniele Limonta (daniele.limonta@alettibank.it)
- Massimiliano Marcellino (massimiliano.marcellino@eui.eu)
- Alessandro Stanzini (alessandro.stanzini@alettibank.it)
- Maria Eleonora Traverso (mariaeleonora.traverso@alettibank.it)

with the collaboration of:

- Alberta Martino (alberta.martino@eui.eu)

Report closed on May 19 2014

EXECUTIVE SUMMARY

- ❖ A major question in the current global economic context is whether or not the euro area crisis is finished.
- ❖ Financial markets seem to think so, given the major recovery in stock indexes and the low public and private bond prices also for the euro peripheral countries. However, the real economy still presents substantial unbalances in several euro countries and various risk elements are present.
- ❖ In this report we analyze the main positive and negative arguments in favour of a marked and permanent improvement in the economic and financial conditions in the euro area.

EXECUTIVE SUMMARY

The main elements suggesting that the situation in the euro area is recovering are:

1. Positive growth data in the past quarters in several countries
2. Encouraging business' and households' surveys
3. Improved financial conditions in Southern Europe
4. Improved conditions in the real estate market
5. Less restrictive fiscal policy
6. Expansive monetary policy
7. Creation of a series of institutions that should favour a stronger economic and monetary union (Fiscal Compact, OMT, ESM, SSM)

The main risk factors include:

1. The labour market situation is dramatic and will probably not improve in the short run
2. Credit market remains fragmented, with access difficulties and diverse rates
3. The AQR and stress tests are necessary and useful, but in the short term they do not help, just like Tapering in the US if accelerated
4. Inflation might remain very low for a long time, increasing real costs of private and public debt and giving an incentive to postpone consumption and investment
5. A strong result for extremist parties at the European elections could have important effects on a national level
6. A sudden stop in emerging countries would create market volatility and a contraction in commerce
7. The Ukraine scenario could degenerate

EXECUTIVE SUMMARY

Overall, we retain a positive view on the economic performance of the euro area.

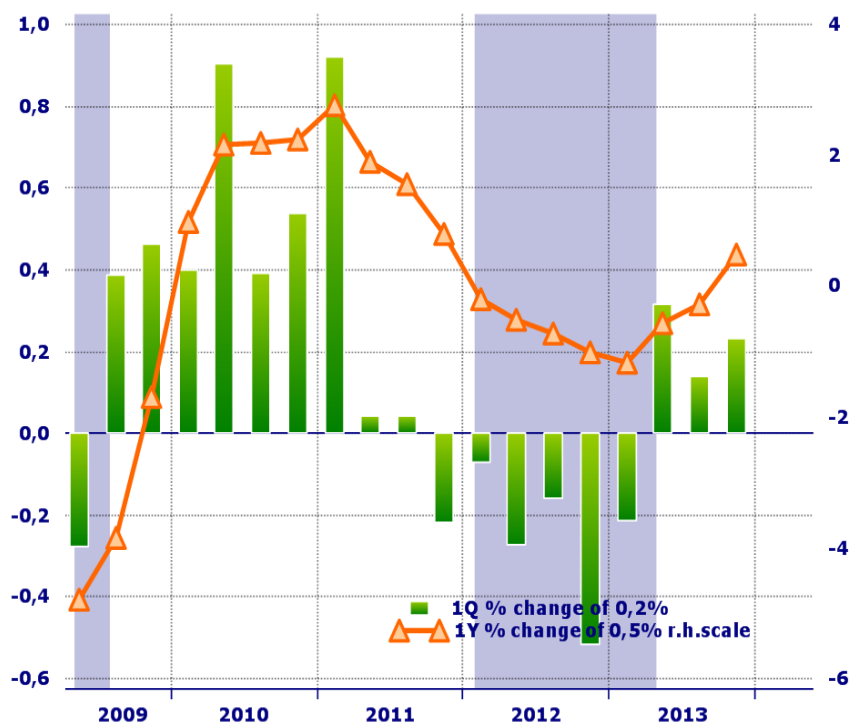
We expect GDP growth of about 1-1.2% for 2014, increasing to about 1.6% in 2015. The major driver of growth is the German economy, whose GDP will likely grow well above 2%. We expect positive growth also in France and Italy, about 0.8% and 0.4% respectively, with values above 1% for both countries in 2015.

Inflation will remain subdued, we expect about 0.8% in 2014 and 1.2% in 2015. For core inflation we predict similar values, about 0.7% in 2014 and 1.0% in 2015.

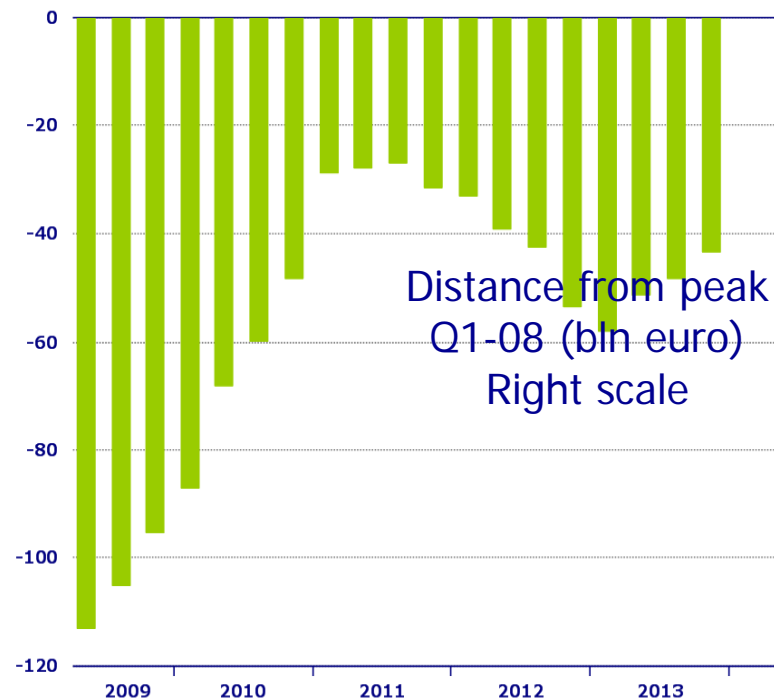
THE END OF THE EURO AREA CRISIS?

In Q1-2014, Eurozone aggregate income grew by 0.2% compared to the previous period, growing for the fourth quarter in a row; recovery started accelerating after the slowdown of 2013's second semester. GDP's trend growth rate, +0.9%, is the highest since mid 2011 and suggests an acceleration of the economy. Income level is still well below pre-crisis values, but highest of the past two years.

GDP DYNAMICS (fig.1)

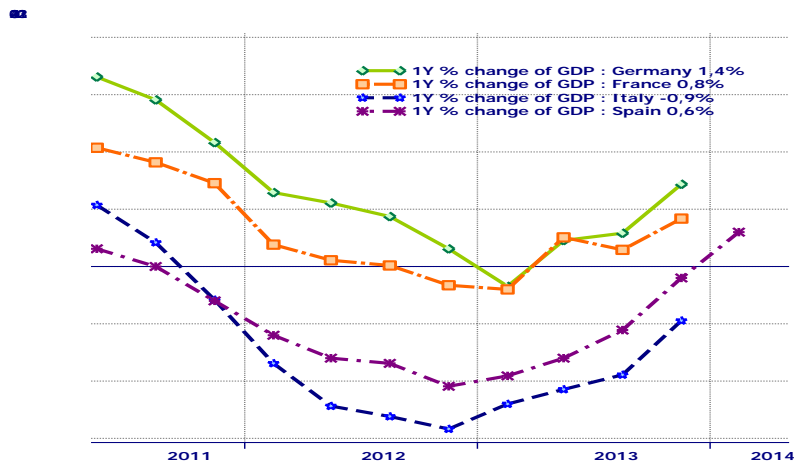


DISTANCE FROM PEAK (fig.2)

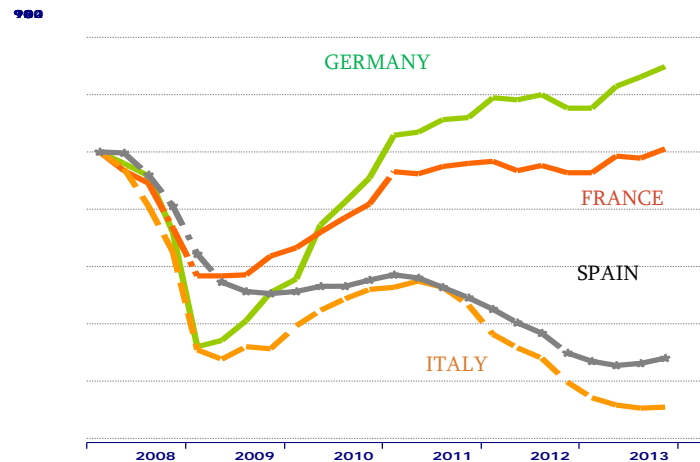


Germany is the driving economy, with an income increase of 0.8% on previous quarter and of 2.3% on a yearly basis (highest since 2011). France's growth is null (+0.0%), but the trend rate is amply positive (+0.8%) and highest of the past two years. Spain grew by 0.4% vs. previous period, generating the greatest growth since beginning of 2008. Italy, with its GDP correction (-0.1%), registers negative yearly growth rate.

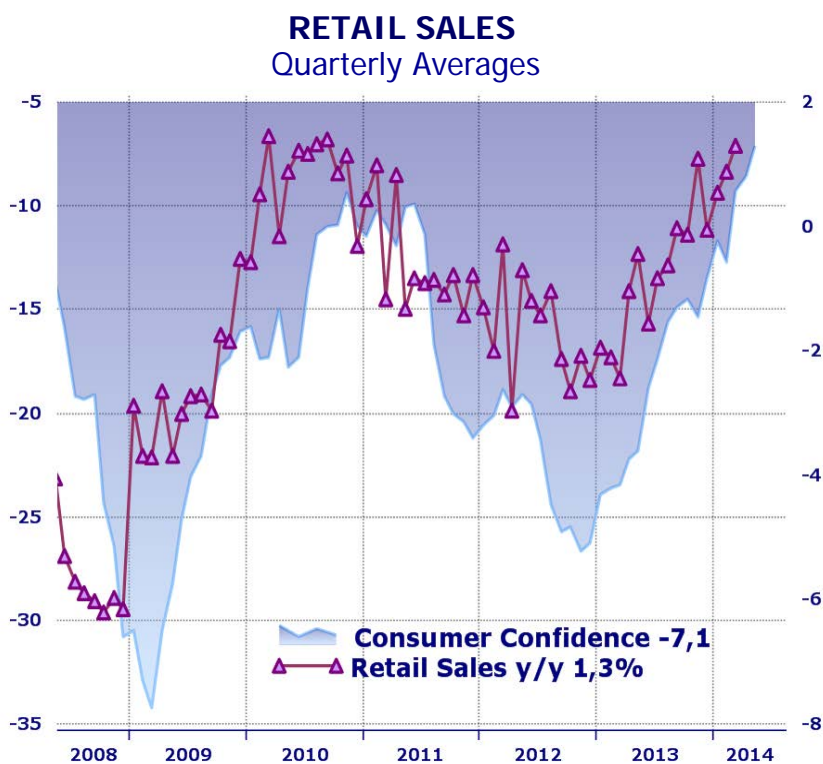
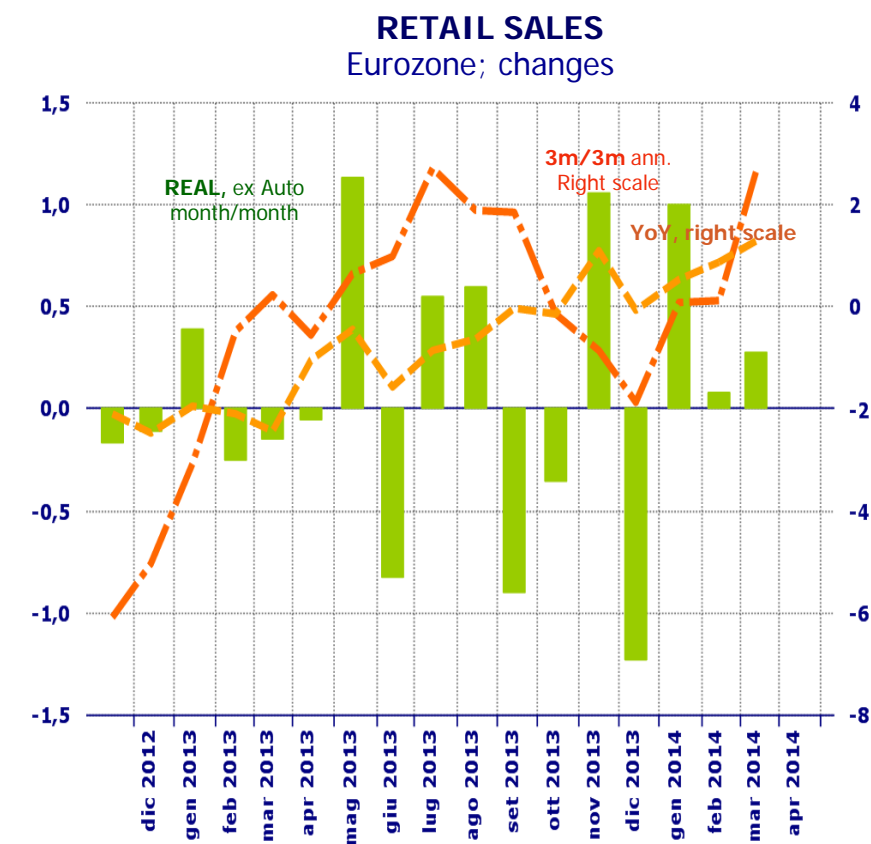
TREND CHANGE (fig.2)



COMPARATIVE LEVELS (fig.3)

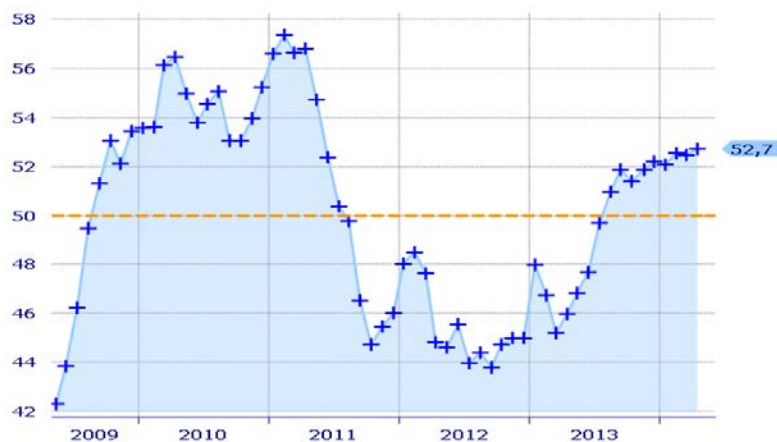
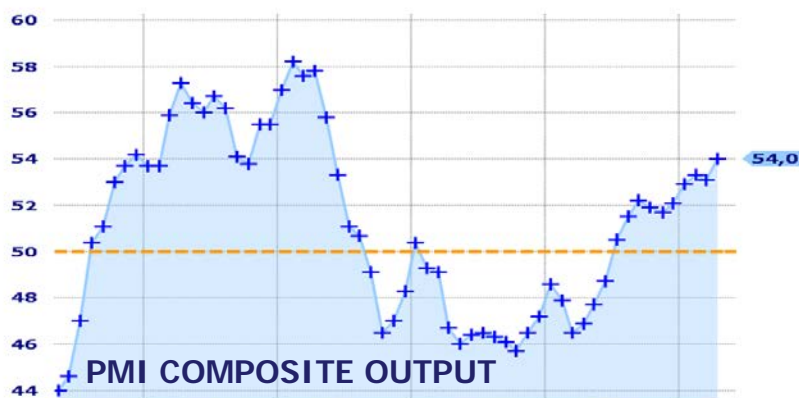


In March 2014, aggregate retail sales in Eurozone registered a better than expected dynamic, growing by 0.3%, vs. an expected -0.2% contraction. Trend growth rate is at +1.3%, a four year high. Increase in private consumption is triggered by constant progression in households' consumer confidence, that in April registered end of 2007's highs.



BUSINESS' QUALITATIVE INDEXES

Eurozone's recovery accelerated at the beginning of second quarter, with economic activity expanding at a faster pace than the past three years, based on PMI Composite index. Simultaneous improvement in manufacturing (53.4) and services (52.1); the index relative to this compartment reported the highest level since mid 2011.

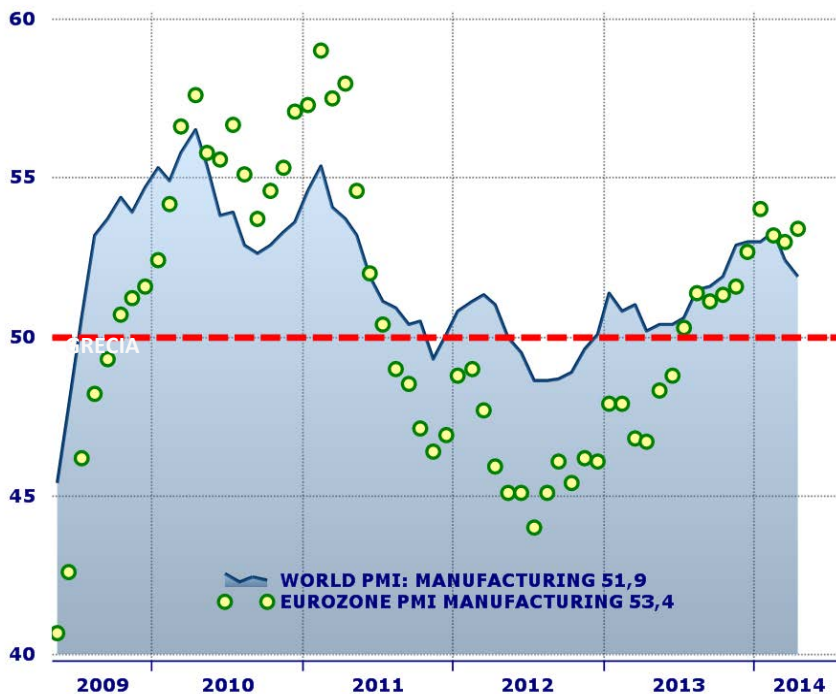


BUSINESS' QUALITATIVE INDEXES

In 2014, Eurozone's Manufacturing PMI was higher than global PMI, inverting the negative difference of European vs. Global economy, persistent in the previous three years. According to the industrial businesses' purchasing managers survey, Eurozone's economy is second only to the US, while China and Japan feature a sensible instability.

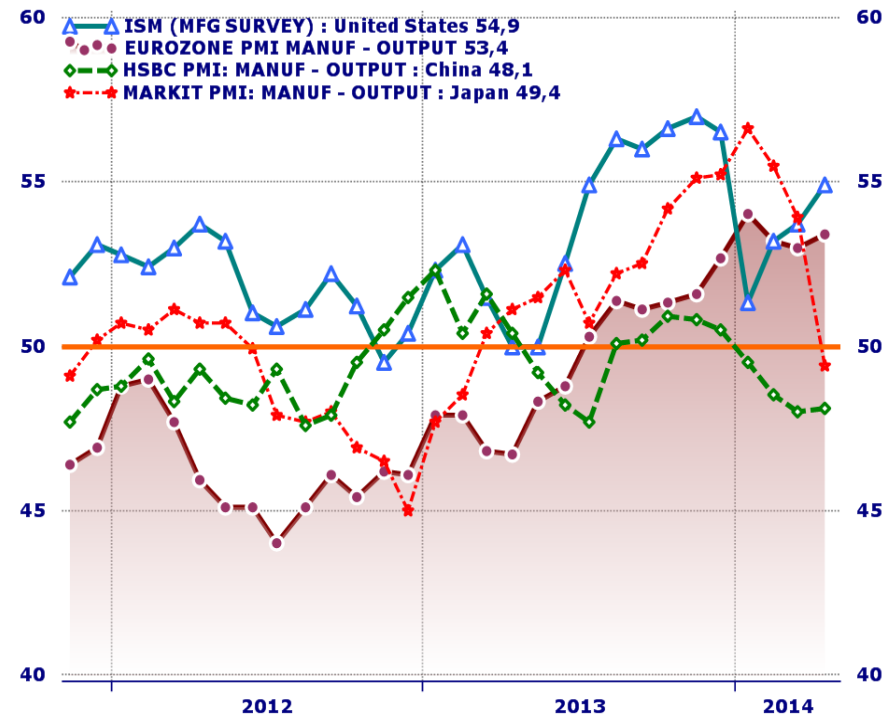
EUROPE AND INTERNATIONAL CYCLE

PMI Manufacturing indexes comparison



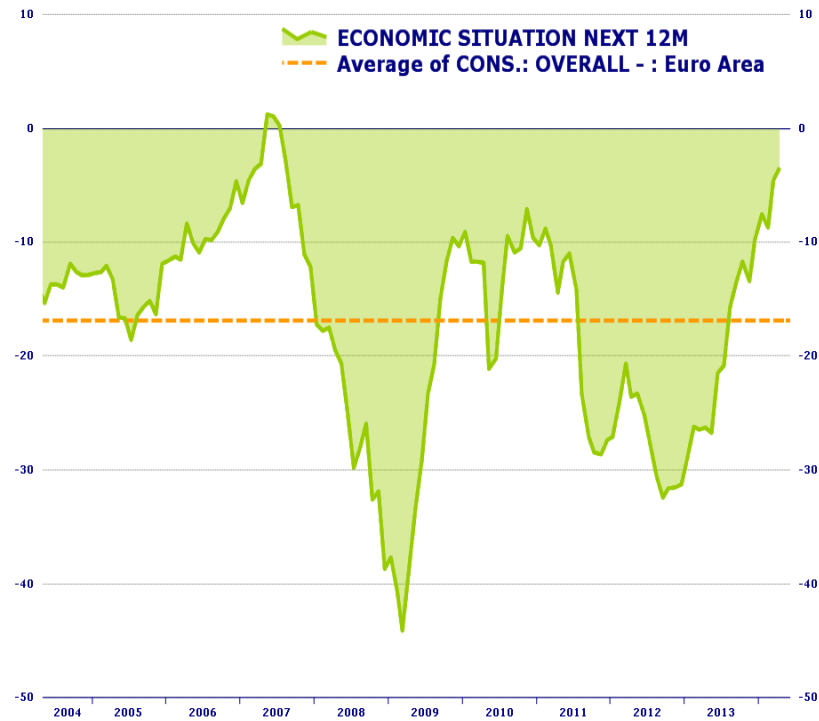
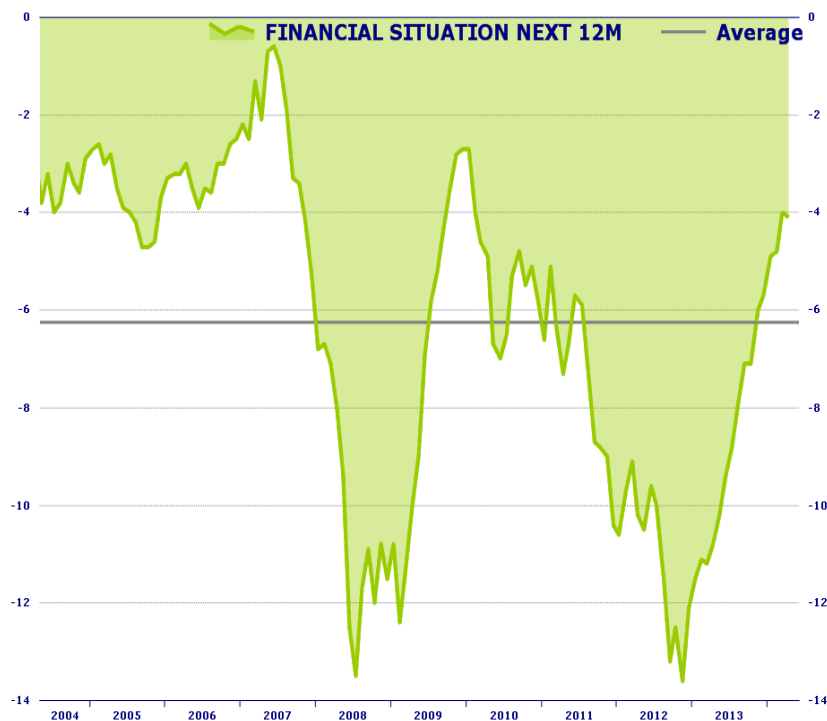
EUROPE AND INTERNATIONAL CYCLE

PMI Manufacturing indexes comparison



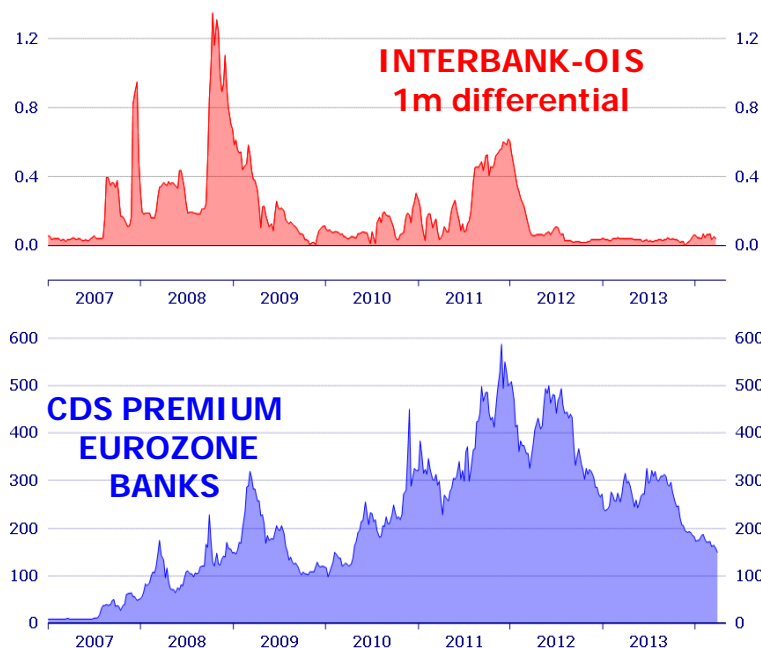
HOUSEHOLDS' QUALITATIVE INDEXES

According to April survey, European households' financial expectations are highest since 2009's highs, while expectations on the economy are best since 2007. Both indicators are on values greatly higher than long term averages.



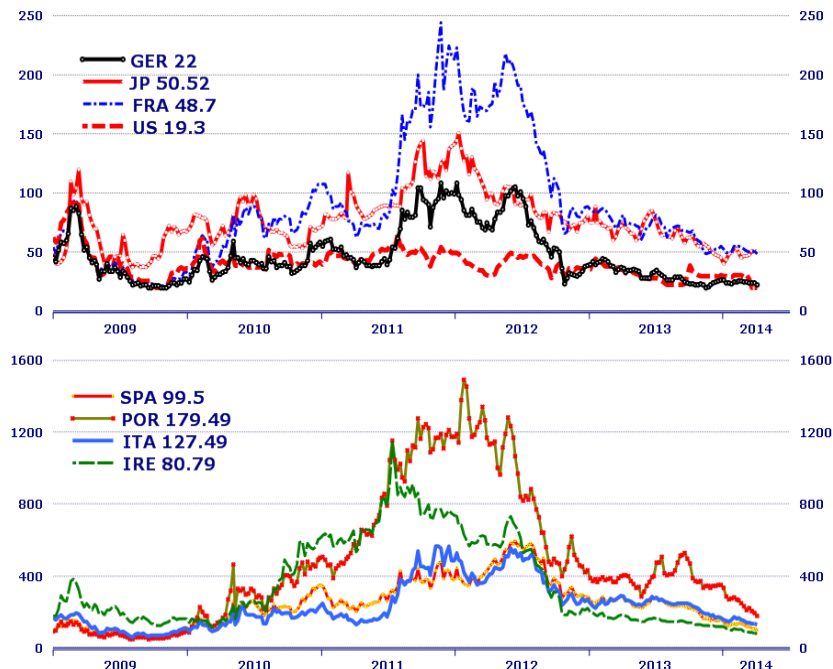
Banks' and countries' perceived risk is greatly reduced...

OIS SPREAD & CDS € BANKS



COUNTRY RISK– CDS 5 YEAR

5 year Credit default swap

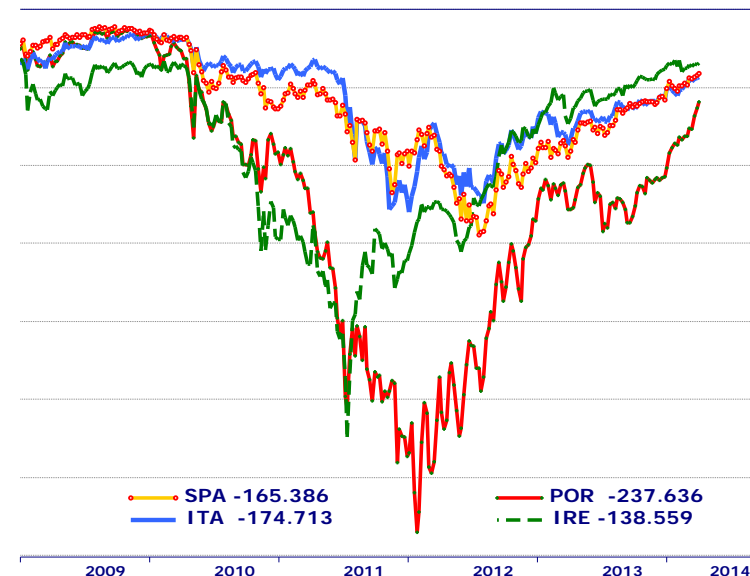


... as long term spread on public bonds vs. Germany....

COUNTRY RISK

Rating and differential on German ten-year rates

	Moody's	S&P	Fitch
France	Aa1	AA	AAA
Germany	Aaa	AAA	AAA
Greece	Caa3	B-	B-
Ireland	Baa3	BBB+	BBB+
Italy	Baa2	BBB	BBB+
Portugal	Ba3	BB	BB+
Spain	Baa2	BBB-	BBB
Japan	Aa3	AA-	AA-
USA	Aaa	AA+	AAA

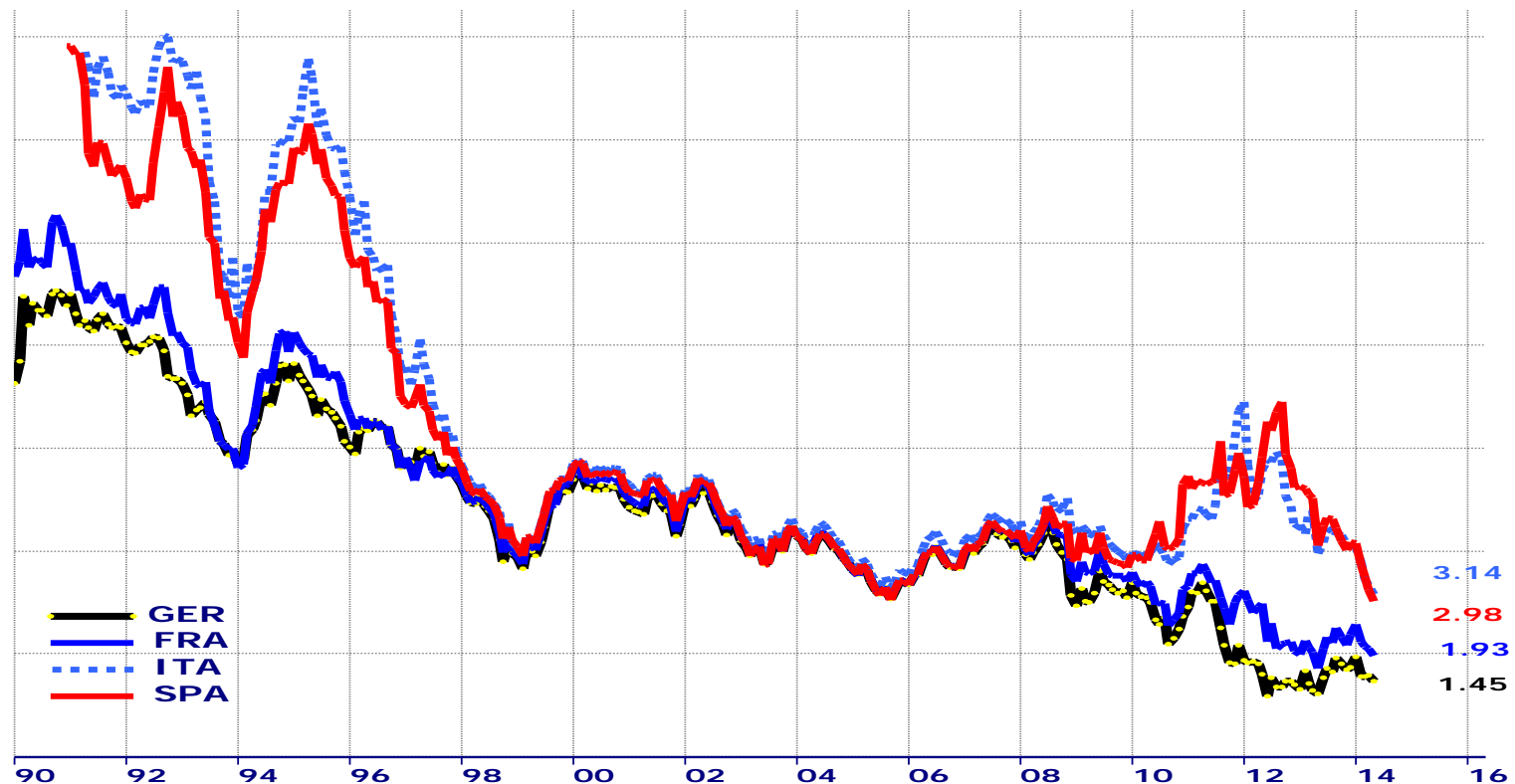


Source Bloomberg, rating 04/2/2014
CSDR

... and levels of 10 year rates (although it's better to examine real rates that so far have decreased a bit less).

EUROZONE TEN YEAR RATES

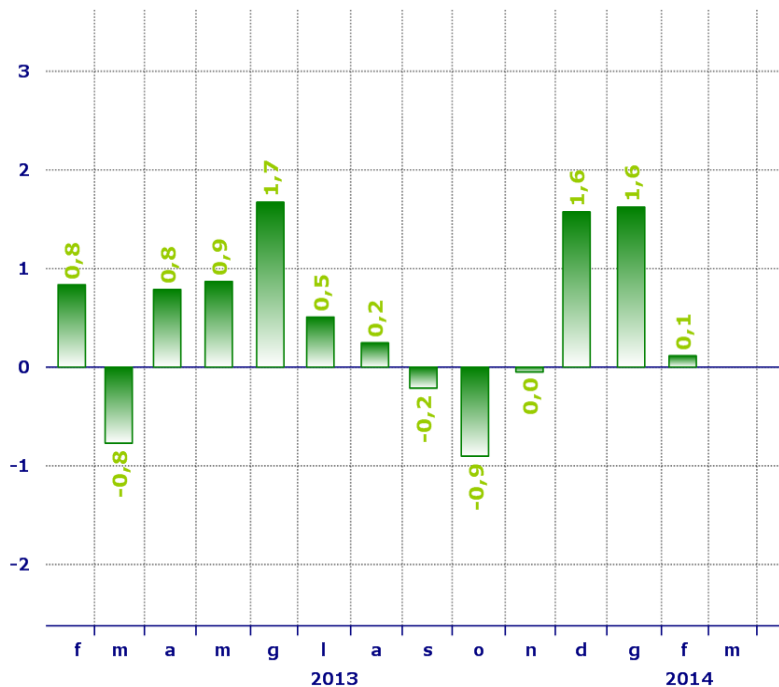
Benchmark bonds



After a prolonged period of contraction, also the housing market starts to return stable ...

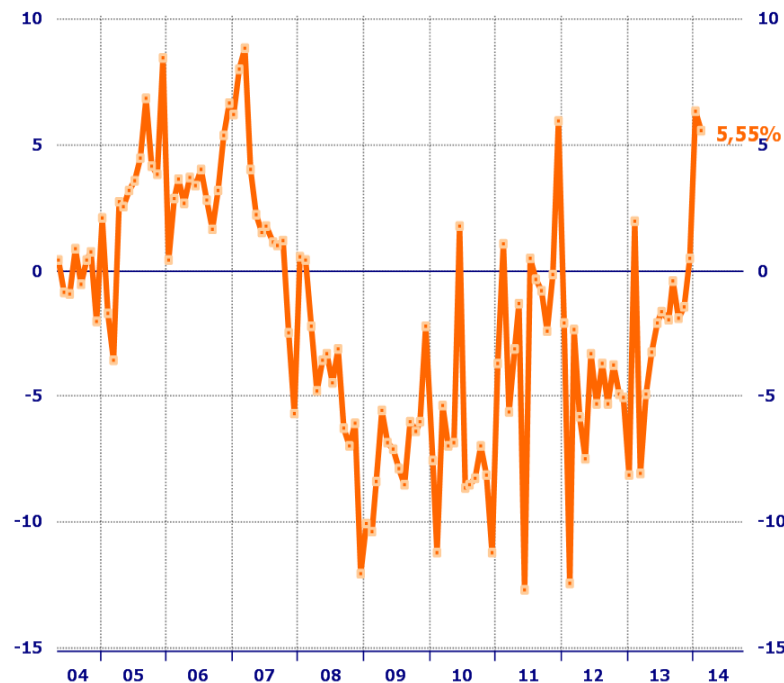
BUILDING PRODUCTION

Monthly changes

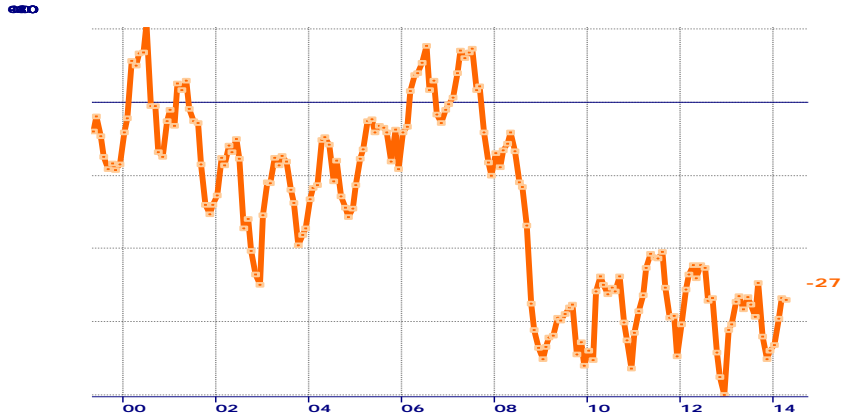


BUILDING PRODUCTION

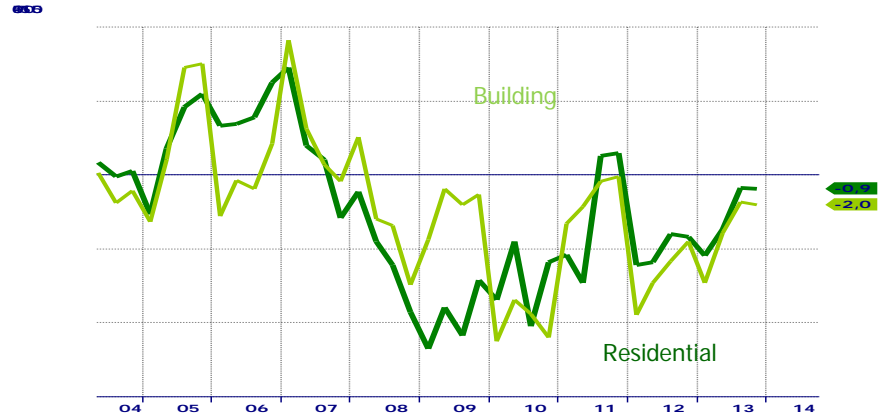
Yearly changes



HOUSING SECTOR CONFIDENCE INDEX



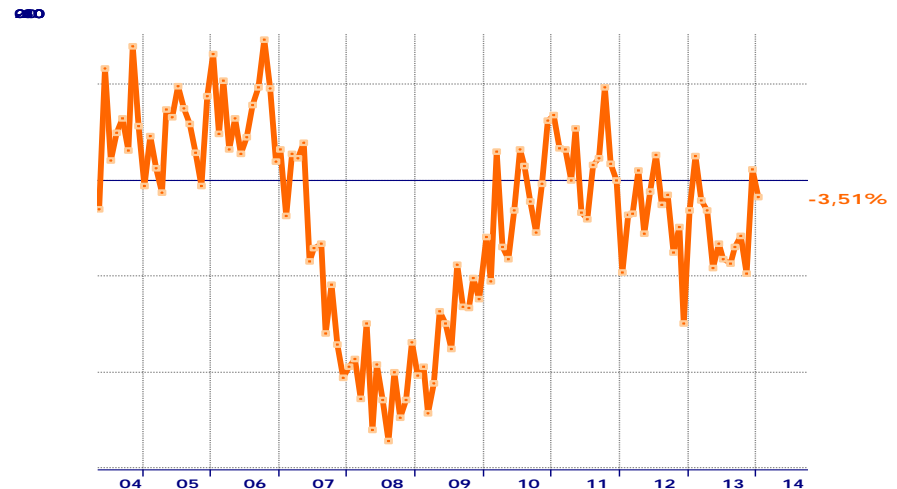
BUILDING PRODUCTION



HOUSING PERMITS index



HOUSING PERMITS Yearly change

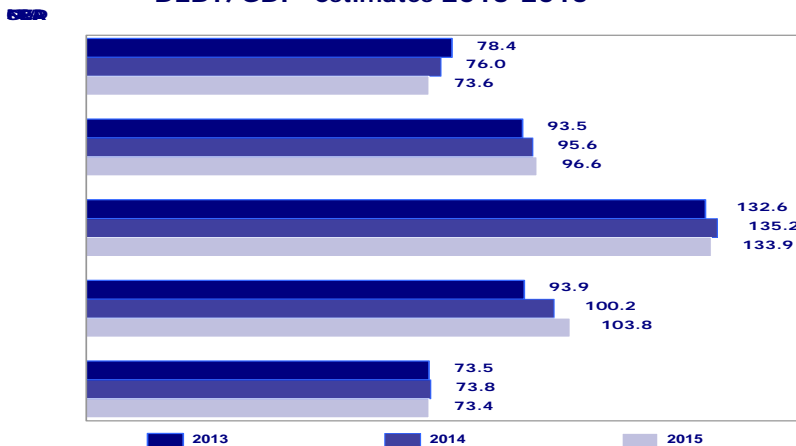


FISCAL POLICY

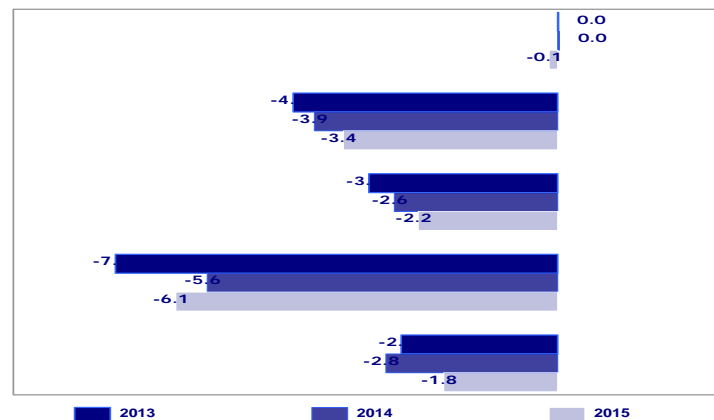
EU COMMISSION'S FORECASTS

Fiscal policy becomes a bit less restrictive, not only in the euro area

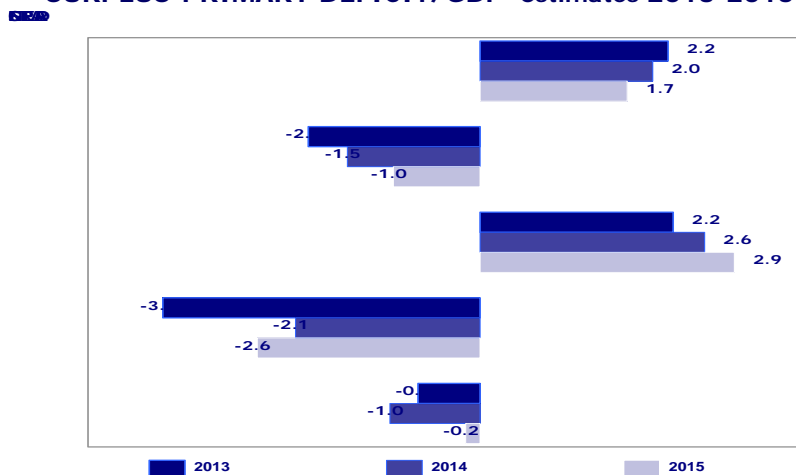
DEBT/GDP estimates 2013-2015



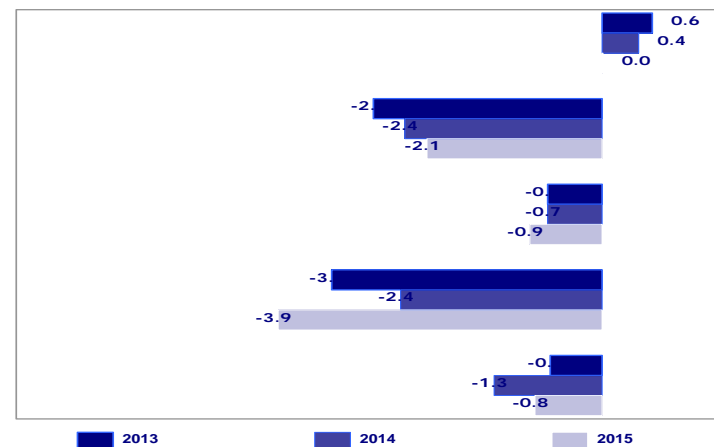
DEBT-SURPLUS/GDP estimates 2013-2015



SURPLUS-PRIMARY DEFICIT/GDP estimates 2013-2015

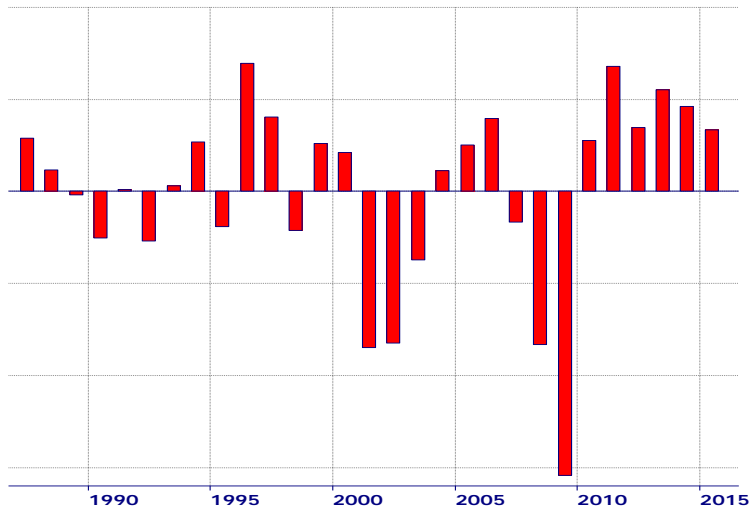


DEBT-SURPLUS/GDP ADJUSTED FOR THE CYCLE



OECD COUNTRIES – PRIMARY BALANCE ADJ. FOR THE CYCLE

OECD data – quota % change on potential GDP

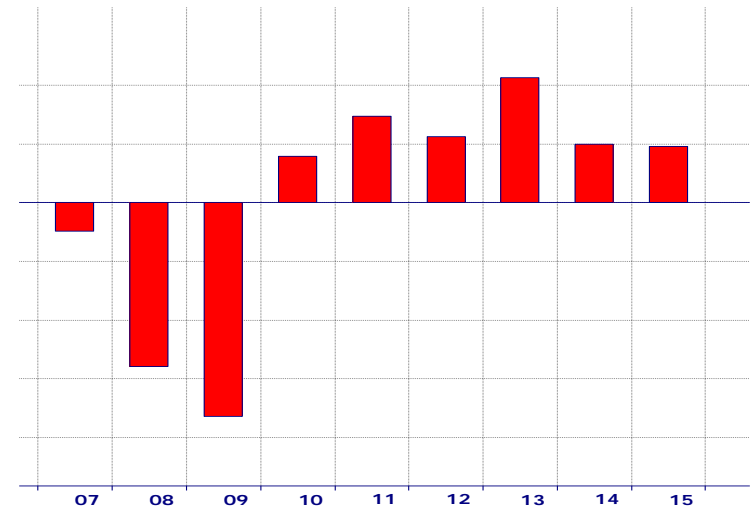


FISCAL RESTRICTION

FISCAL EXPANSION

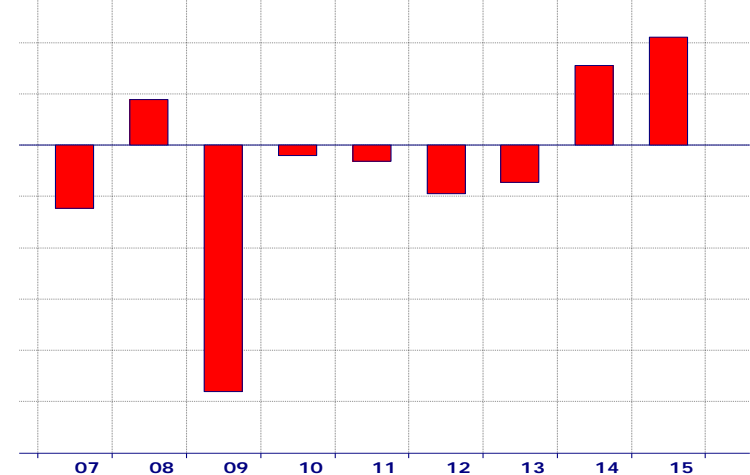
USA – PRIMARY BALANCE ADJ. FOR THE CYCLE

OECD data – quota % change on potential GDP



JAPAN – PRIMARY BALANCE ADJ. FOR THE CYCLE

OECD data – quota % change on potential GDP

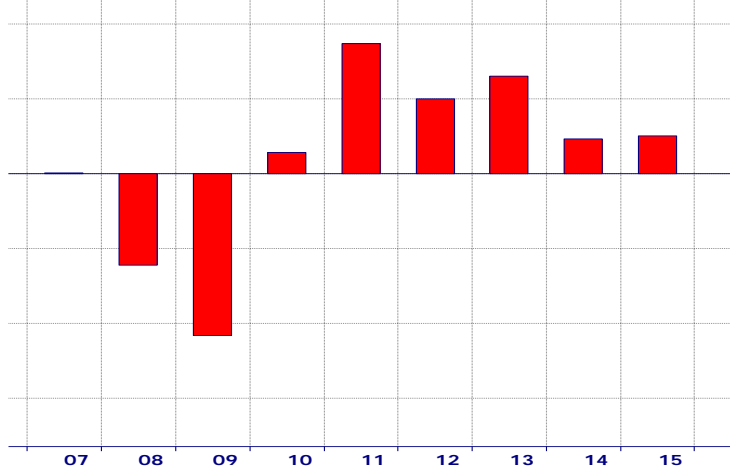


FISCAL RESTRICTION

FISCAL EXPANSION

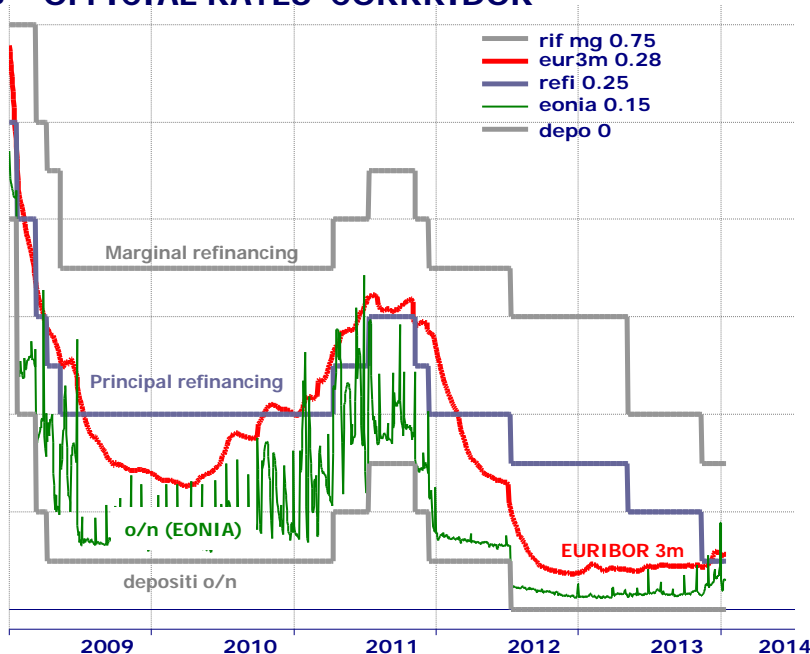
EUROZONE – PRIMARY BALANCE ADJ. FOR THE CYCLE

OECD data – quota % change on potential GDP



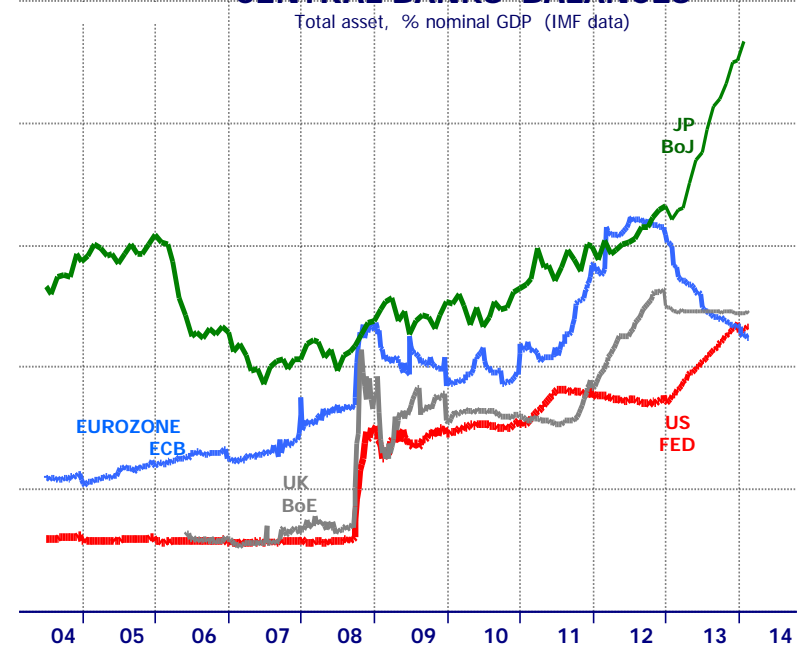
In the May meeting, the ECB Steering Committee kept rates unchanged and avoided recourse to unconventional measures, in line with market consensus. However, President Draghi declared the possibility to activate all available options, including acquisition of financial assets (QE Fed style), non sterilisation of government bonds in SMP (over 200 bln in ECB style QE, i.e. not effective), negative rates on deposits, or other measures on liquidity in favour of private credit, directly or through the credit system.

ECB – OFFICIAL RATES' CORRIDOR

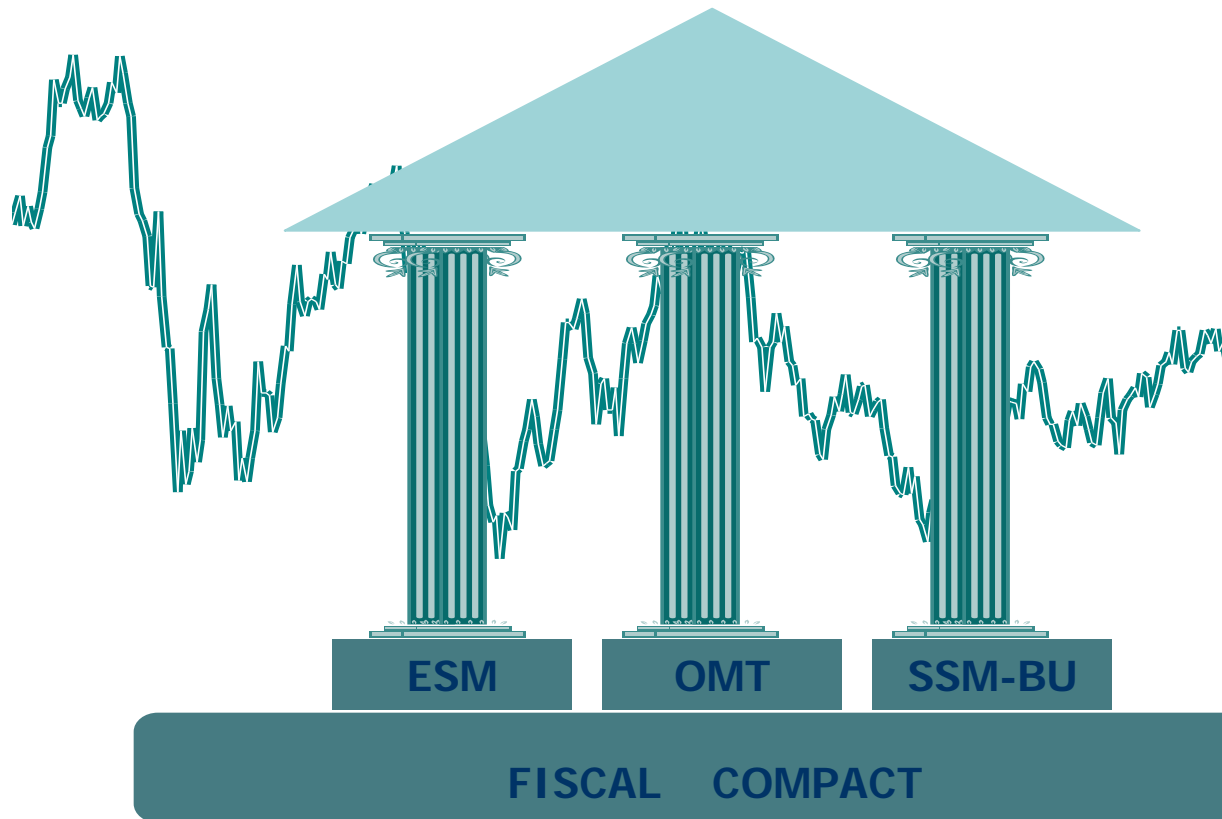


20

CENTRAL BANKS' BALANCES



THE PILLARS



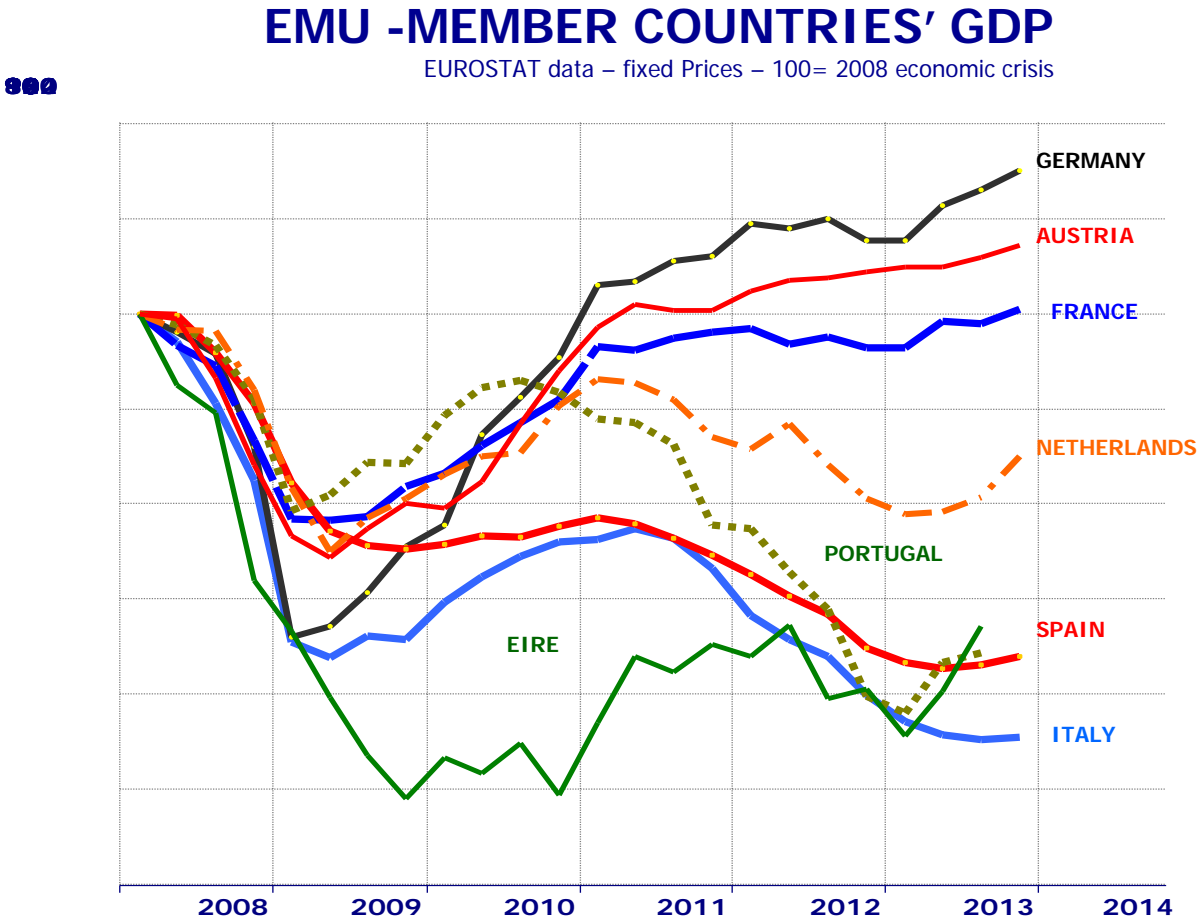
FISCAL COMPACT agreement for a more rigid financial regulation, in line with sustainability targets

ESM bailout fund (700bln, of which: 190Ger/ 142,7Fra/ 125,4Ita/ 83,3Spa/ 40Ned/ 24,3Bel...)

OMT ECB Government bond acquisition programme in case of speculative attacks

SSM-BU centralized supervision on 130 banks and banking union with funds for failures

GDP is still way below pre-crisis levels, especially in Southern European countries.

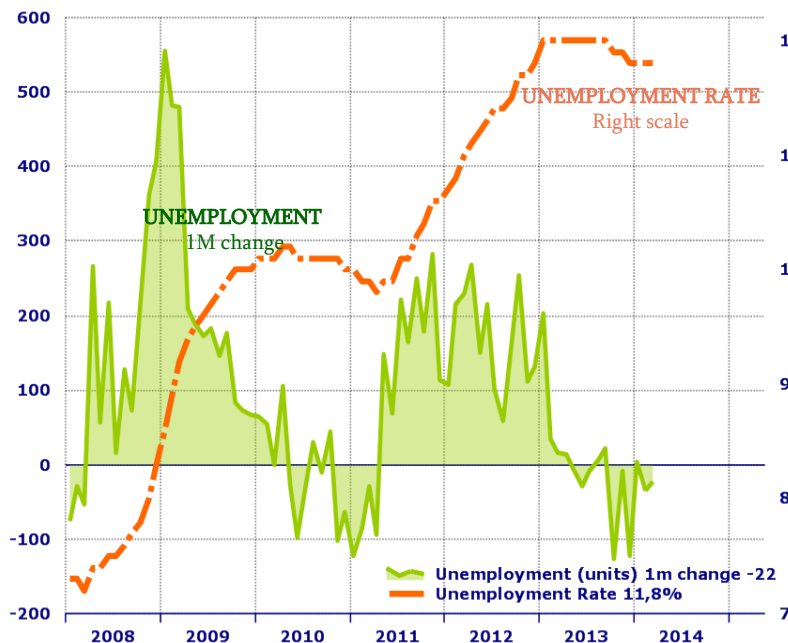


LABOUR MARKET

Unemployment reduction since mid 2013, unemployment rate's stabilisation below peak, plus improved expectations (Employment sub-index of PMI survey at 50.7, best since end of 2011), certify that aggregate labour market has passed the point of cyclical low...

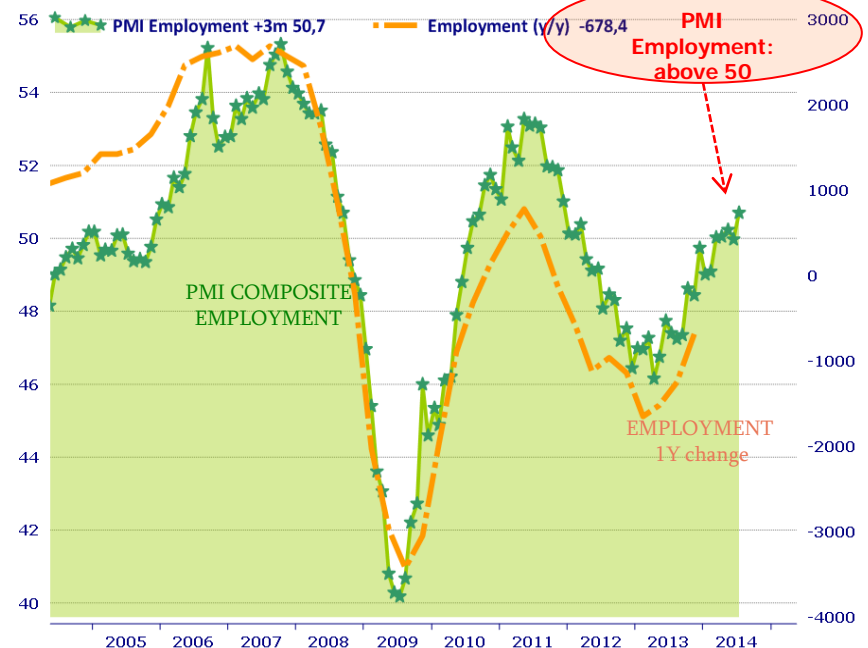
LABOUR MARKET

Unemployment



LABOUR MARKET

Employment and Expectations

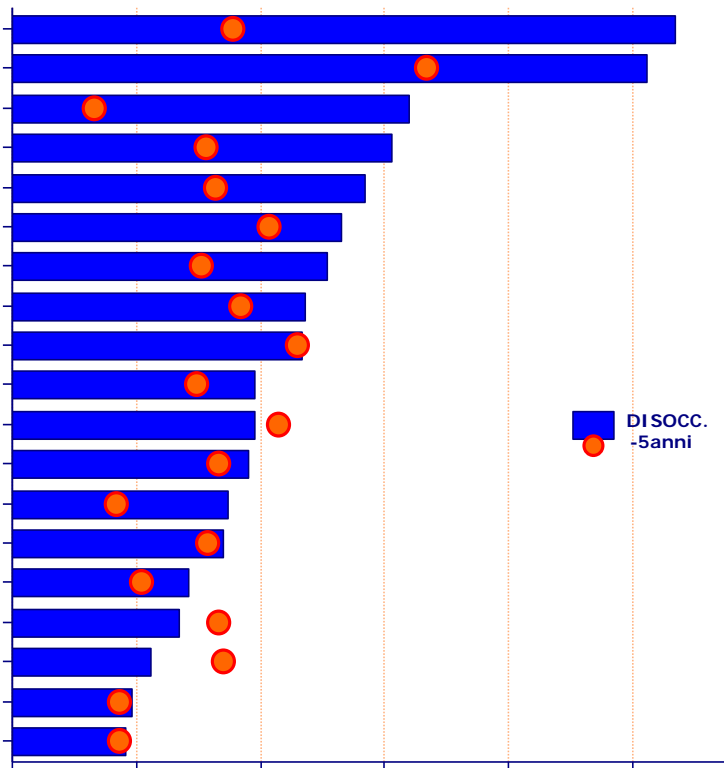


LABOUR MARKET

... but the situation is dramatic in several countries.

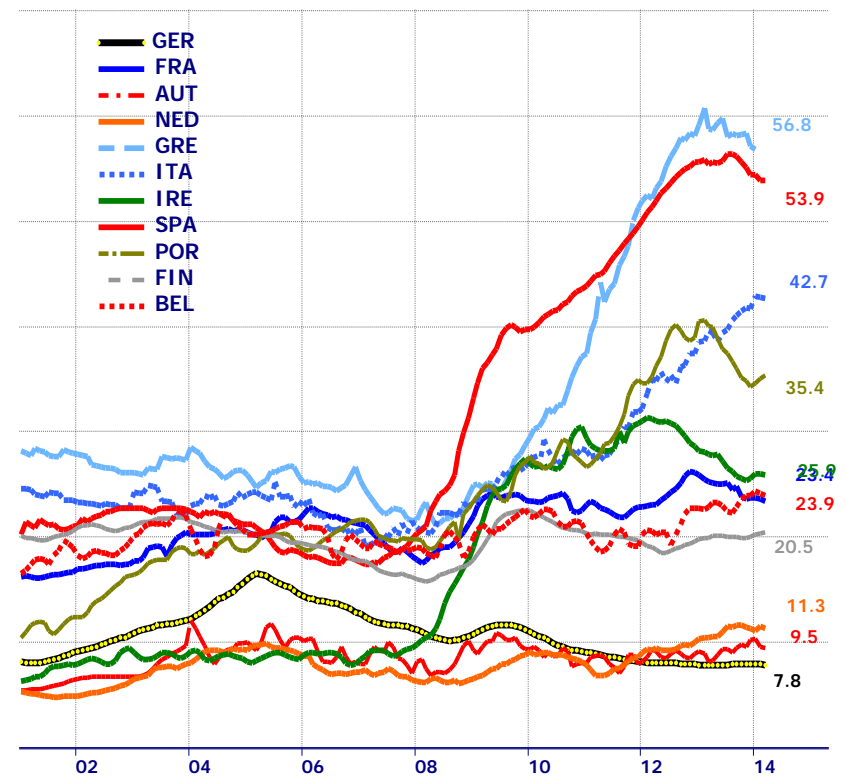
UNEMPLOYMENT RATE

Source: NATIONAL STATISTIC OFFICES



YOUTH UNEMPLOYMENT

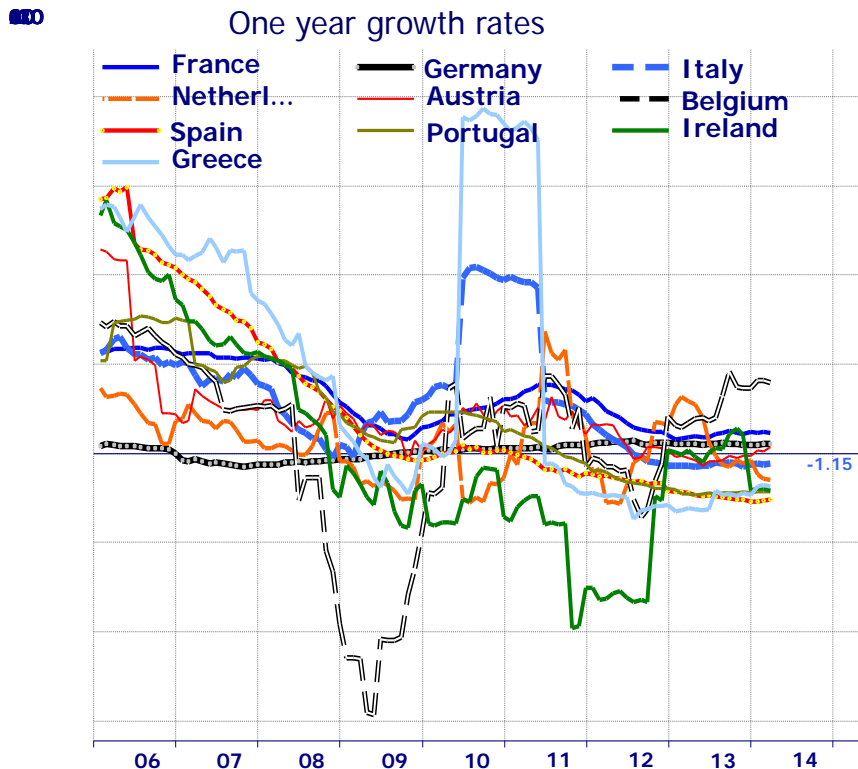
Source EUROSTAT



In several countries credit access is difficult both for households and businesses...

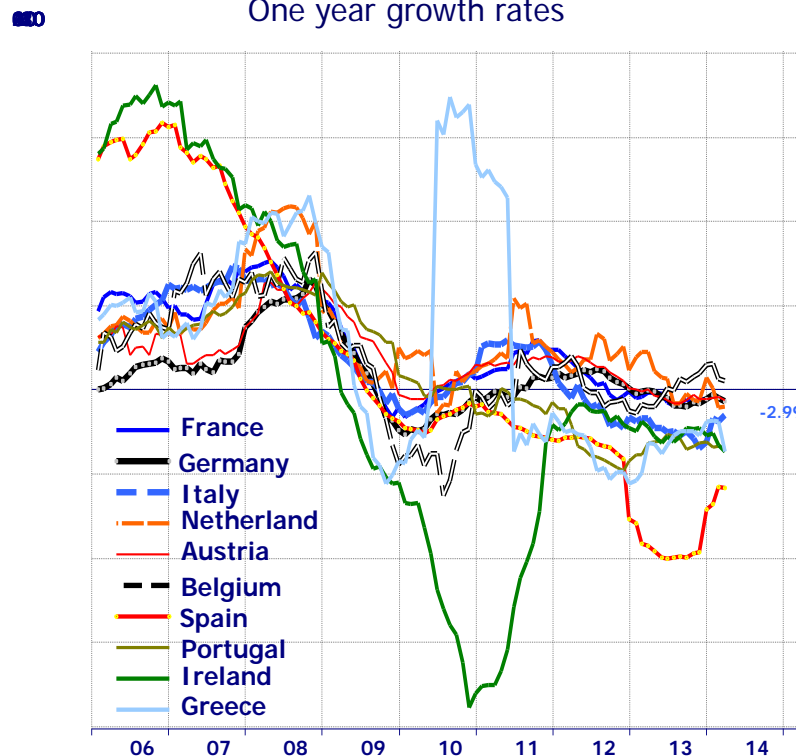
BUSINESS CREDIT- TREND

One year growth rates



HOUSEHOLD CREDIT- TREND

One year growth rates

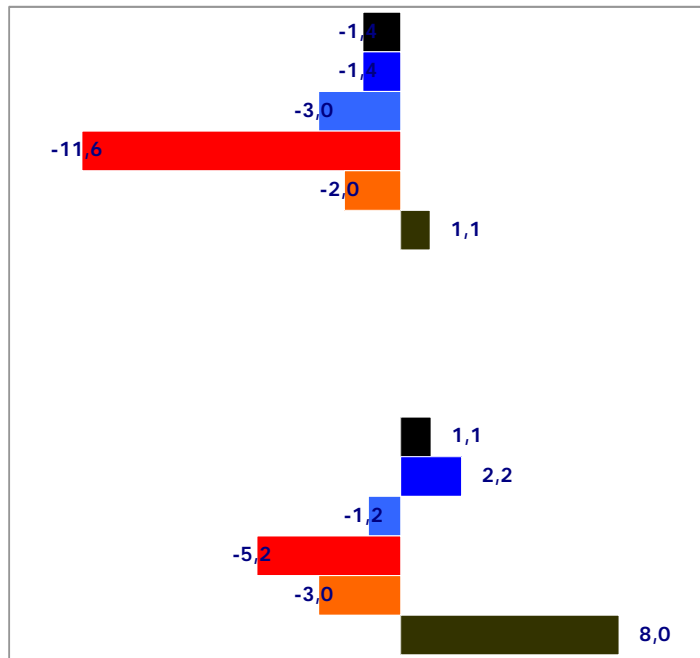


... the situation is improving very slowly...

BUSINESS AND HOUSEHOLDS CREDIT

One year growth rates

BUSINESS CREDIT



GER
SPA

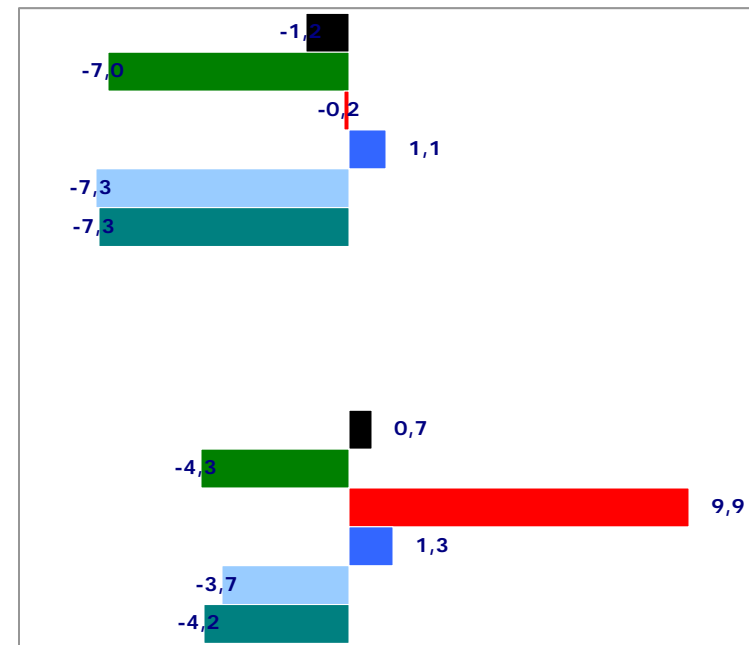
FRA
NED

ITA
BEL

BUSINESS AND HOUSEHOLDS CREDIT

One year growth rates

BUSINESS CREDIT



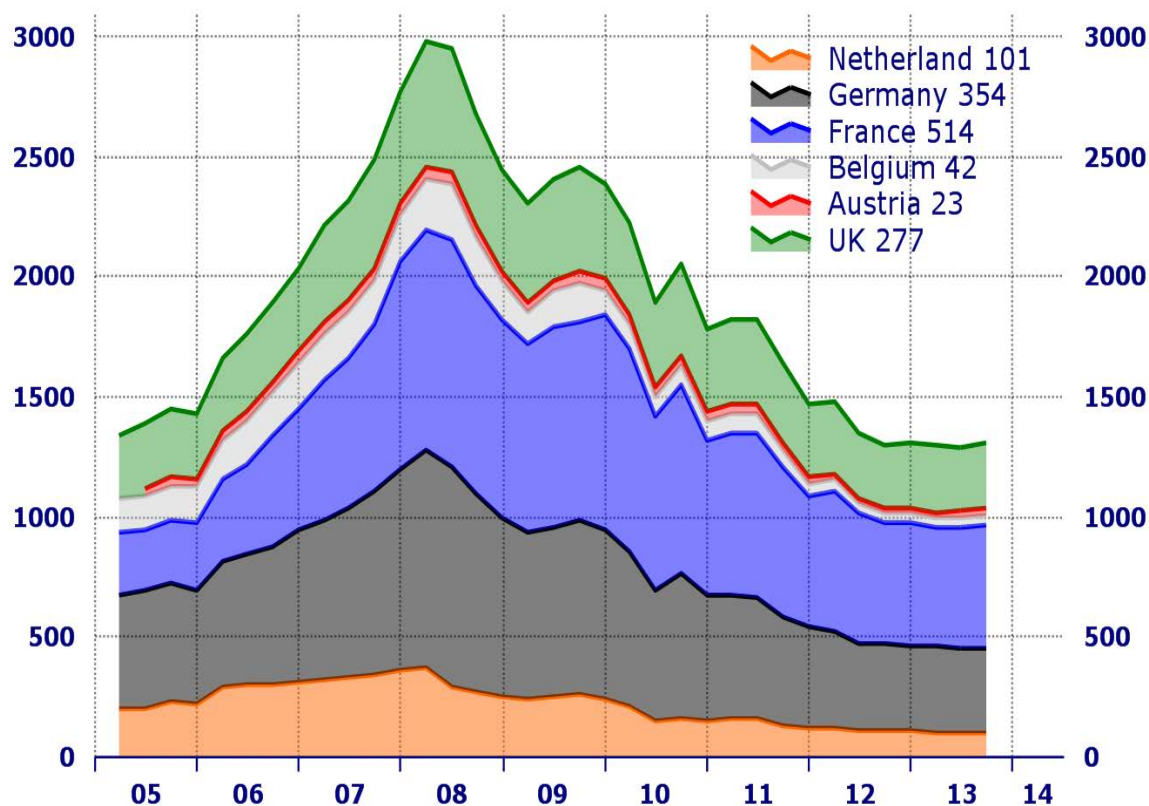
AUS
FIN

POR
GRE

SLK
IRE

CREDIT MARKET

... on an aggregate level, banking market fragmentation remains high...



BANKS' COMMITMENTS vs PERIPHERAL COUNTRIES

Banks' aggregate data vs Italy, Eire, Greece, Spain and Portugal

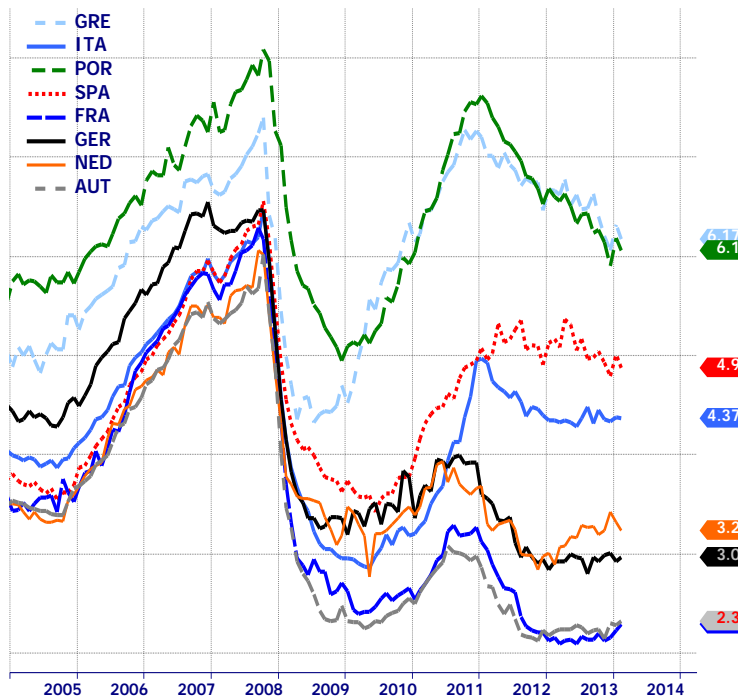
... and rates' differentials between countries remain significant, as do rates' levels in some countries.

The AQR and stress tests certainly don't help.

The end of tapering in the USA and, in the medium term, the increase in US rates are another risk factor (although they could help in terms of exchange rate).

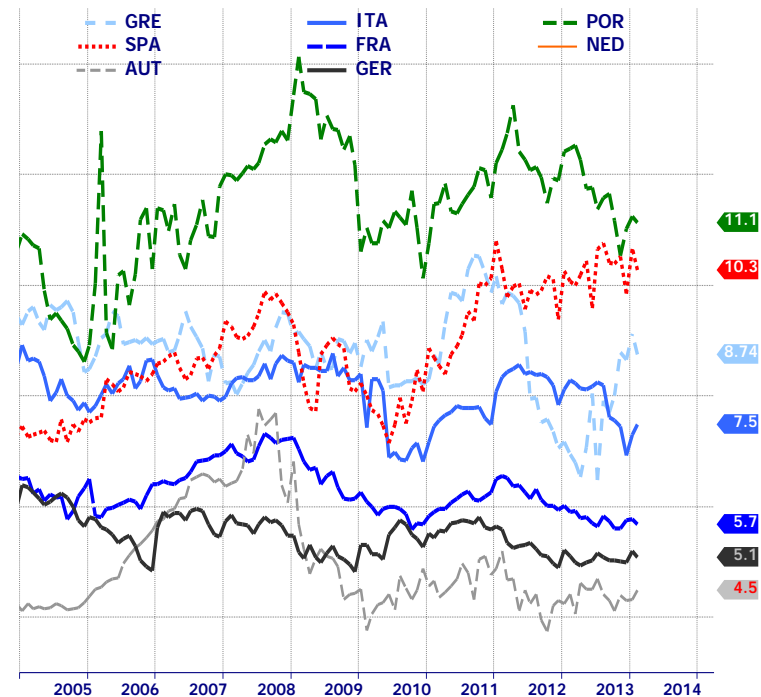
INTEREST RATES ON CREDIT

Business credit under 1 bln euro



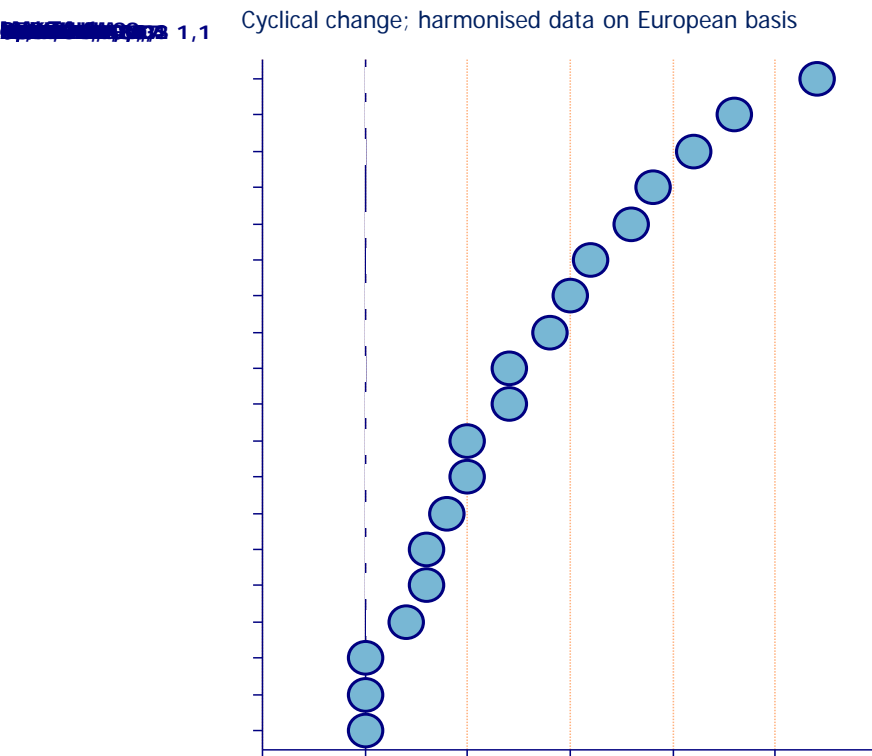
INTEREST RATES ON CREDIT

Consumer credit – variable rate 1-5 years



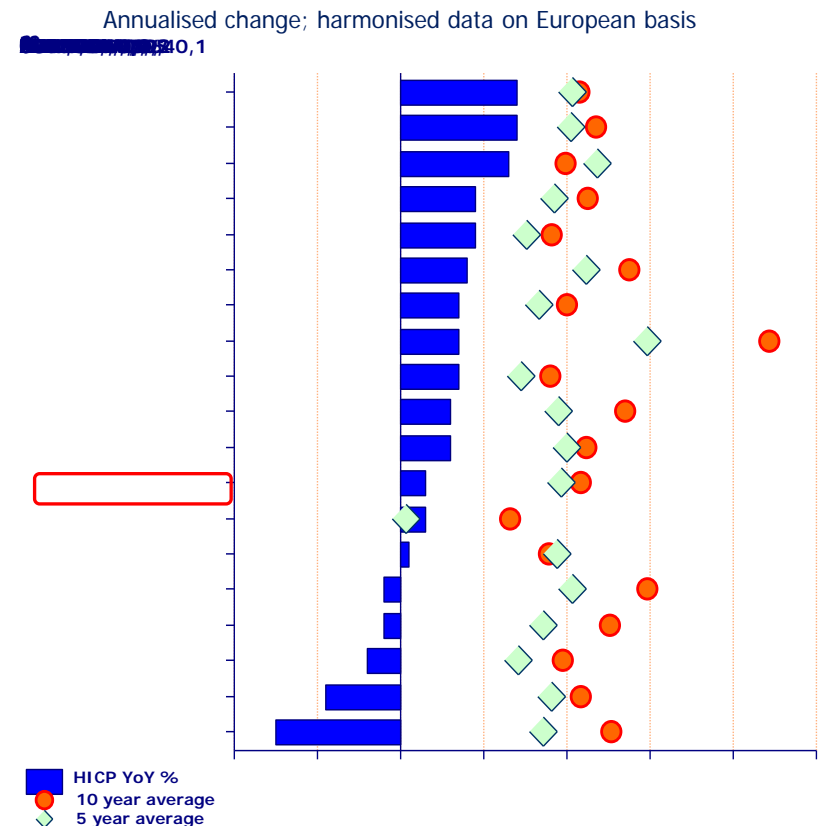
In the month of April 2014, the final inflation figure was at 0.7%, up from March's 0.5%, lowest since November 2009. In all Eurozone countries, trend inflation is lower than short and long term averages. Low inflation increases the real cost of private and public debt and encourages to postpone investment and consumption.

INFLATION BY COUNTRY



March 2014 data, except Eurozone (April '14)

INFLATION BY COUNTRY

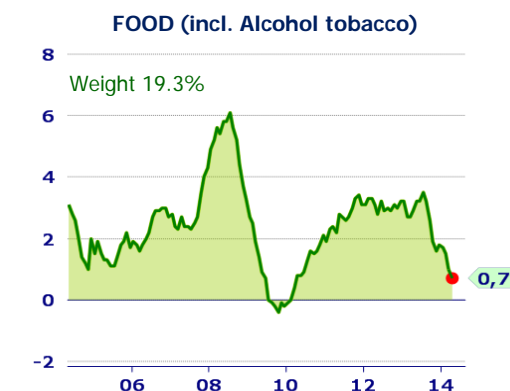
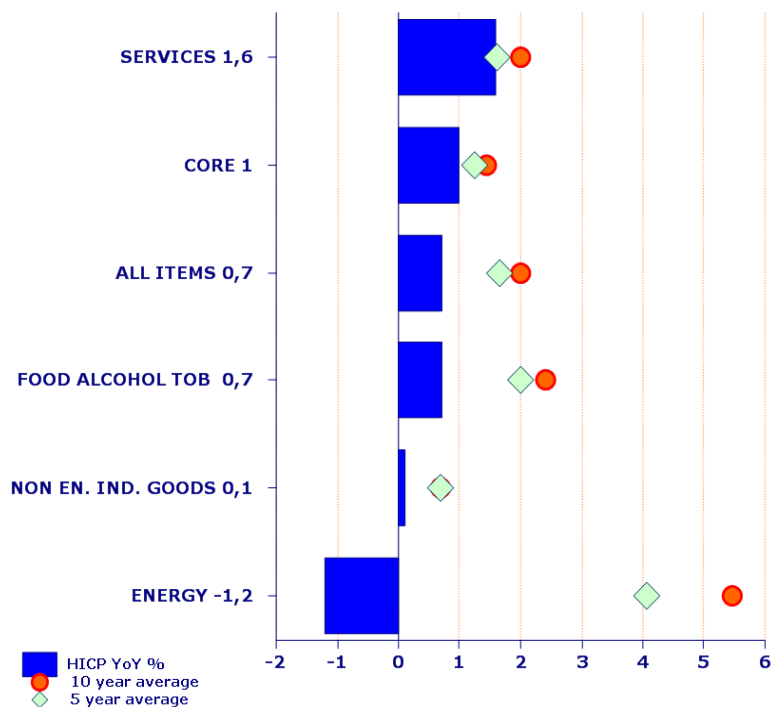


INFLATION

Also in April the principal contribution to deflation comes from the evolution of energy prices.

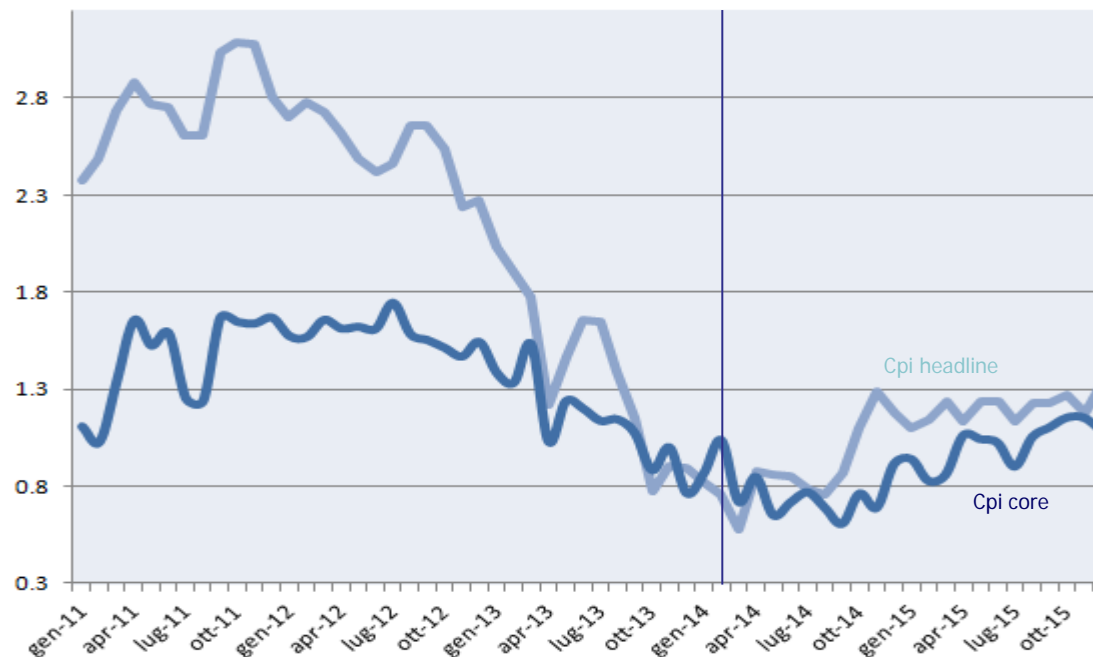
INFLATION BY MACROSECTOR

Annualised change

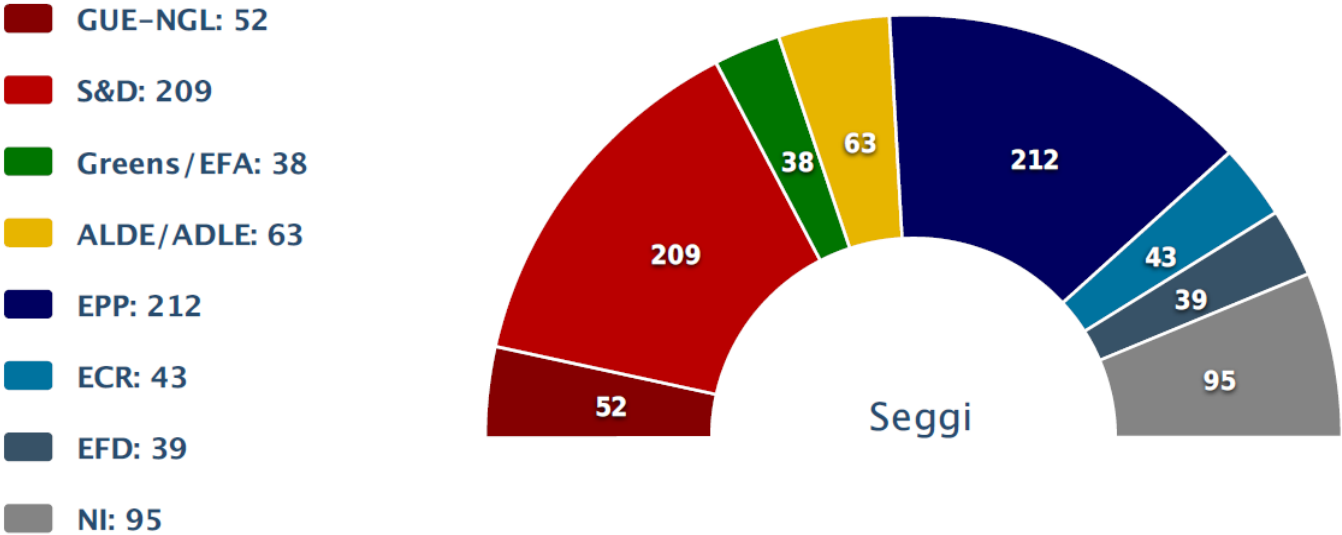


INFLATION

Up to September 2014, general inflation will remain around 1%, under pressure from ample unused resources in labour and goods' markets, with a weak economic recovery. Only starting in October it will rise and favourable impulses will intensify in 2015. However, the persistent negative output gap will bind price dynamics, keeping it far from 2%. **Average rate +0.8% in 2014, +1.2% in 2015.** For core inflation we foresee a declining profile for the first three quarters of this year, with a +0.6% low in the final months of 2014 and a gradual increase towards 1% in 2015. **Average rate +0.7% in 2014, +1.0% in 2015.**



A marked victory of anti-European populist parties could influence national politics, possibly undermining Governments. Both elements could increase uncertainty and have negative effects on financial markets and the economy.



EPP	European People's Party	ECR	European Conservatives and Reformists
S&D	Socialists & Democrats	GUE/NGL	European United Left/Nordic Green Left
ALDE	Alliance of Liberals and Democrats for Europe	EFD	Europe of Freedom and Democracy
Greens/EFA	Greens/European Free Alliance		

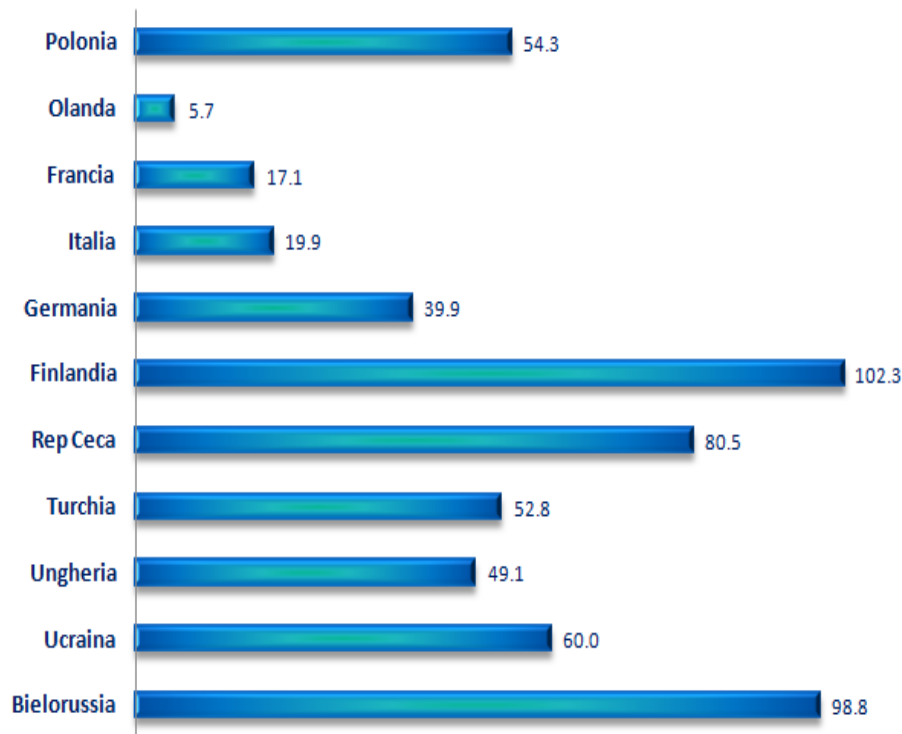
Source: Pollwatch2014

UKRAINE – RUSSIA CRISIS

The dependency of certain European countries in the euro area on Russia's energy supplies is great, as are the trade ties.

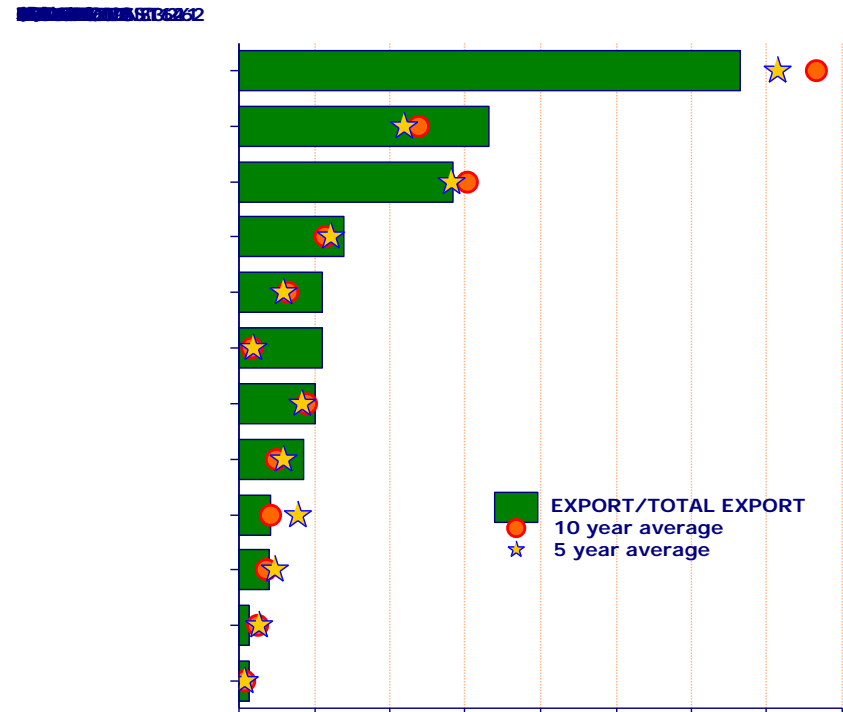
EUROPEAN DEPENDENCY ON RUSSIAN GAS

Weight of Russian gas on total



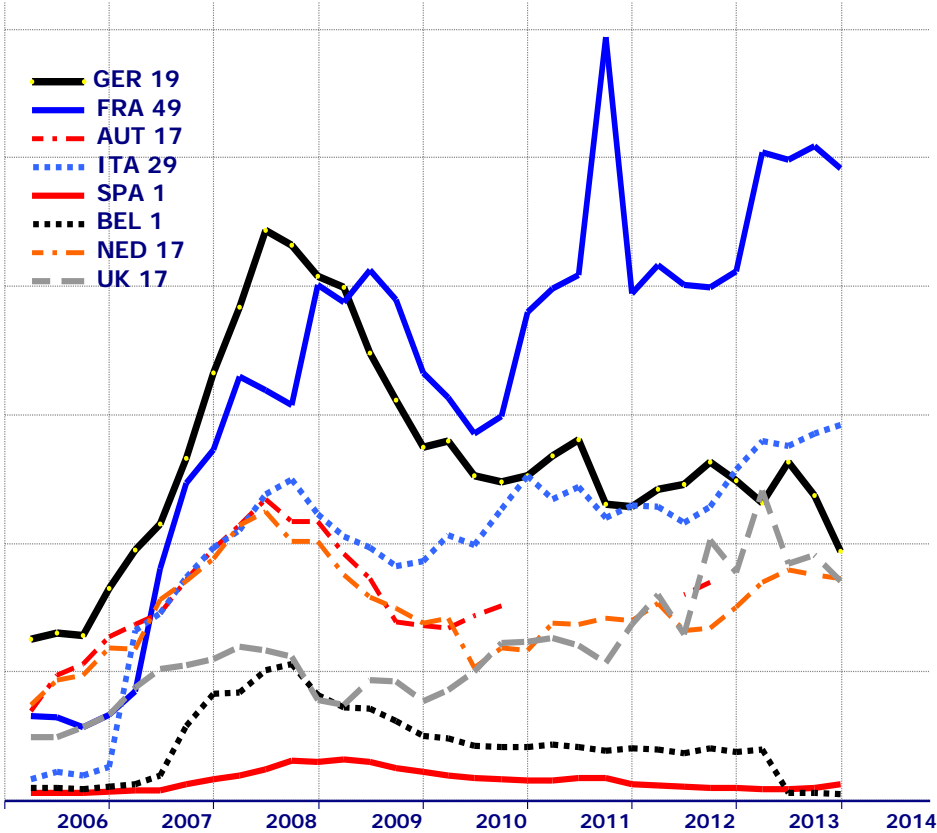
RUSSIA – EXPORT

Export quotas versus single countries and areas



Banks’ exposure is overall limited for single countries, but on the Eurozone aggregate level it’s worth over 120 bn dollars.

80



EUROPEAN BANK
EXPOSURE VS RUSSIAN
BANKS
Bln USD– Source BIS

CHINA - SUDDEN STOP?

Main phenomenons:

ECONOMY SLOWDOWN

- ❖ Drop in exports
- ❖ Lower than expected growth for production, sales and investment
- ❖ Qualitative indicators' decrease

EASENING OF PRICE PRESSURE

- ❖ Stronger deflation upstream in the supply chain
- ❖ Decreasing inflation at consumption stage
- ❖ Decrease in qualitative indicators

SHANGHAI CHAORI SOLAR DEFAULT

- ❖ This company, that operates in materials for solar energy production, announced on 4 March 2014 that it will not be able to pay interests on a 5-year bond (expiry 2017). Bond worth 1 bln RMB, 8.98% coupon.
- ❖ First technical default on the internal bond market in the recent history of the system

INCREASING WORRIES ON CHINA'S BRUSC LANDING

- ❖ Instant adjustment in raw materials' prices

CHINA - SUDDEN STOP?

The correct interpretation of Chinese slowdown cannot exclude the context it belongs to...

Domestic authorities are trying to create

The greatest change in the
economic policy of the past
twenty years ...

Balancing growth, inflation and
employment targets.

IN A NUTSHELL

Various elements suggest that the situation in the euro area is recovering:

1. Positive growth data in the past quarters in several countries
2. Encouraging business' and households' surveys
3. Improved financial conditions in South Europe
4. Improved conditions in building market
5. Less restrictive fiscal policy
6. Expansive monetary policy
7. Creation of a series of institutions that should favour economic union (Fiscal Compact, OMT, ESM, SSM)

IN A NUTSHELL

However risk factors remain:

1. The labour market situation is dramatic and will probably not improve in the short run
2. Credit market remains fragmented, with access difficulties and diverse rates
3. The AQR and stress tests are necessary and useful, but on the short term do not help, just like Tapering in the US, when accelerated
4. Inflation might remain very low for a long time, increasing real cost of private and debt and thus giving an incentive to postpone consumption and investment
5. A strong result for extremist parties at the European elections could have important effects on a national level
6. A sudden stop in emerging countries would create market volatility and a contraction in commerce
7. The Ukraine scenario could degenerate

DISCLAIMER

The content of the preceding pages has been prepared by Banca Aletti&C. S.p.A. (“Banca Aletti”) together with the European University Institute. Banca Aletti – belonging to the Gruppo Banco Popolare – is a broker authorized by law, listed in the Register of Banks, number 5383.

With this document Banca Aletti proposes to its customers’ evaluation information retrieved from reliable sources in the system of financial markets and – where deemed necessary – its own opinion on the matter with possible commentary (notes, observations, evaluations).

We point out that the information provided, communicated in good faith and on the basis of data available at the moment, could be inexact, incomplete or not up to date and is apt to variation, even without notice, at any given moment.

This document cannot be in any way considered to be a sales or subscription or exchange offer, nor any form of soliciting sales, subscriptions or exchange of financial instruments or of investment in general and is neither a consulting in financial investment matters.

Banca Aletti is not responsible for the effects deriving from the use of this document. The information made available through the present document must not be considered as a recommendation or invitation on Banca Aletti’s side to accomplish a particular transaction or to perform a specific operation.

Each investor should form his own independent persuasion, based exclusively on his own evaluations on the opportunity to invest. The decision to undertake any form of financial operation is at the exclusive risk of the addressees of the present disclaimer.

The source of all data and graphs is provided by Thomson Reuters where not otherwise specified.